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Direct Tax Alert

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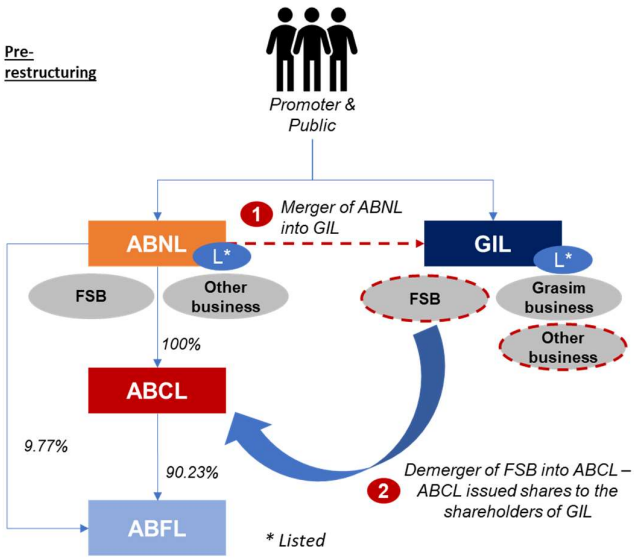
Mumbai ITAT rules on demerger of Financial Services business

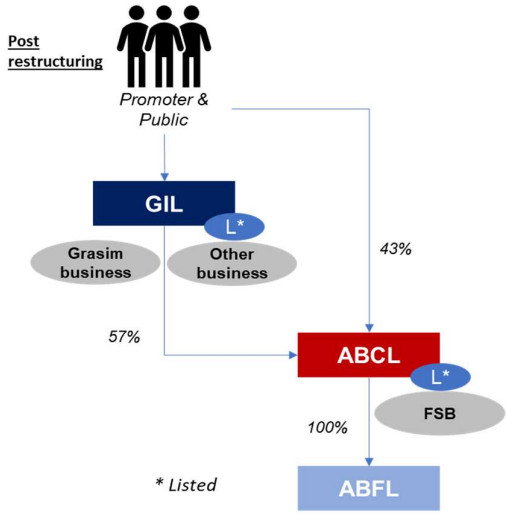
The Mumbai bench of the Income-tax Appellate Tribunal ("ITAT") in a recent ruling in the case of Grasim Industries Limited[1] ("GIL" or "the Taxpayer") has ruled that demerger of *'financial services business'* is a tax compliant transaction under section 2(19AA) of the Income-tax Act, 1961 ("Act") and not taxable under section 2(22)(a) of the Act and accordingly, the Taxpayer is not liable to pay dividend distribution tax ("DDT").

Background and facts of the case

- Aditya Birla Nuvo Limited ("ABNL") was a company engaged in, *inter-alia*, financial services business ("FSB"). ABNL acquired FSB comprising of retail asset financing, corporate finance, investment, and financial intermediary business, etc. from Birla Global Finance Limited in 2005. ABNL had a wholly owned subsidiary, Aditya Birla Financial Services Limited ("ABFSL")[2]. ABFSL/ ABCL held 90.23% stake in another company, Aditya Birla Finance Limited ("ABFL") and balance 9.77% was held by ABNL in ABFL.



[1] *ITA No 1935/Mum/2020 and ITA No 41/Mum/2021 – Mumbai ITAT*
[2] *Later on, its name was changed to Aditya Birla Capital Limited ("ABCL")*



- The Board of ABNL and the Taxpayer approved a composite scheme of arrangement ("Scheme") for merger of ABNL into GIL *(Step 1)*, followed by demerger of FSB into ABCL *(Step 2)*.
- The Hon'ble NCLT vide order[2] dated June 1, 2017, approved the Scheme wherein merger was effective w.e.f. July 1, 2017 and thereafter, demerger w.e.f. July 4, 2017 – pursuant to demerger, ABCL issued ~ 92 Cr shares to the shareholders of GIL. Subsequently, such shares were listed on the stock exchanges on September 1, 2017, at a price of INR 261.20 per share.
- As per the Scheme, FSB was a division of ABNL engaged in the activity of fund-based lending, making, holding, and nurturing investments in the financial services sector, together with all its assets (excluding 100% stake held in ABCL), properties, investments and liabilities.
- The Taxpayer demerged the FSB comprising of net assets of INR 1,721 Cr along with employees, officers, liabilities, litigations, etc. Substantial portion (~90%) of total assets comprised of investment in shares of ABFL (9.77%) held by GIL (pursuant to merger of ABNL into GIL – Step 1).

Arguments of the Revenue

- The Tax Officer for the assessment year 2018-19 held that the FSB does not fulfil the requirements of an *'undertaking'* as per explanation 1 to section 2(19AA) of the Act for the reason that the Taxpayer had merely transferred combination of some assets and liabilities without any business activity. He further held that only investment in ABFL (9.77% stake held by GIL post-merger) were transferred as part of the demerger exercise, which was not capable of being run as an FSB on its own as a going concern basis.
- Further, the Tax Officer held that ABNL was not carrying on FSB (pre-merger). At best, it was the holding company of entities which were carrying on FSB. Moreover, FSB was neither shown as a separate segment in the financial statements of ABNL nor in its return of income.
- Additionally, the Tax Officer was also of the view that out of total assets transferred pursuant to demerger of FSB, substantial part of it was represented by 9.77% of equity stake held by the Taxpayer in ABFL.
- It was therefore the contention of the Tax Officer that there is a release of assets by the Taxpayer to its shareholders, indirectly through ABCL since ABCL issued shares to the shareholders of the Taxpayer under the guise of demerger, by allotment of its equity shares.
- Therefore, basis these arguments, the Tax Officer concluded that release of assets by the Taxpayer to its shareholders (through demerger) amounts to deemed dividend u/s 2(22)(a) of the Act and therefore, the Taxpayer is liable to pay DDT u/s 115-O on

[2] *CP (CAA) 32/NCLT/AHM/2017*

this transaction. For ascertaining the tax liability, the Tax Officer adopted the listed price as on the listing date in order to arrive at the quantum of distribution of accumulated profits (~ 92 Cr shares X INR 261.20 per share) totalling to ~ INR 24,037 Cr. The quantum of DDT was ascertained at ~ INR 5,872 Cr (inclusive of interest).

- The CIT (Appeals) concurred with the view of the Tax Officer and held that the Taxpayer does not have a standalone financial business unit and whatever it has under FSB, is in the form of shares of ABFL which does not qualify as an undertaking capable of being run independently, as envisaged u/s 2(19AA) of the Act.
- CIT(A) further held that the distribution of accumulated profits is not necessarily required to be in the form of cash and can also be in kind, both of which are chargeable to tax u/s 2(22)(a) of the Act. However, while ascertaining the quantum of accumulated profits, CIT held that the fair market value is INR 145.40 per share since this value was used by the Taxpayer for a private placement transaction on June 30, 2017. Accordingly, the quantum of accumulated profits was reduced to ~ INR 13,380 Cr (~ 92 Cr shares X INR 145.40 per share).

Arguments of the Taxpayer

- The demerged undertaking as defined in the Scheme meant the FSB engaged in the activity of fund-based lending, making, holding, and nurturing investments in the financial services sector (excluding 100% stake held in ABCL). Basis this, it is evident that the Scheme is based on the fundamental aspect that there is a Financial Service Undertaking, which got demerged from GIL.
- Further, interest income earned on loans given by GIL as part of the FSB have all along been offered to tax under the head 'Profits and gains of business or profession' – this fact is also recognised by the tax department in its various assessment orders for earlier years.
- The Tax Auditor, being an independent expert, has specifically stated in the tax audit report that FSB is one of the businesses of ABNL for various assessment years. Also, the same has been disclosed in the return of income under the column 'Others' since ABNL had multiple businesses and it was not possible to mention the name of every business in the return of income.
- The Taxpayer also mentioned that as per section 230(5) of Companies Act, 2013, a notice was issued to the tax department intimating about the Scheme, but the revenue did not file any objection to the Scheme at that point in time. Now, at the time of assessment, the tax department is attempting to rewrite the scheme already approved by the NCLT which is not in accordance with law and is not permissible.
- The Taxpayer submitted that the assets and liabilities transferred, even *dehors* the shares of ABFL, are more than sufficient to constitute an 'undertaking'. Additionally, professionally qualified employees and officers along with office premises (including furniture, computers, etc.) of the FSB were also transferred as part of the demerged undertaking.
- It was also contended that holding investment in subsidiary companies, is a recognized manner of conducting business activity. In addition to this, external agencies, research houses and investors recognized ABNL's contribution in FSB because of its active involvement and presence in the FS sector. This was also supported by disclosures and discussions in the director's report, and management discussion and analysis report, evidencing the importance of FSB.

- The Taxpayer also argued that the FSB was transferred as a going concern since tangible assets i.e., office, non-current assets, investment, current assets, employees, etc. had been transferred to the resulting company, which are sufficient to independently run the business.
- There is no enrichment at all in the hands of the shareholders of GIL, pursuant to the Scheme. The shareholding of the shareholders of GIL got split into two parts i.e., shares in GIL and ABCL.

On applicability of section 2(22)(a) of the Act

- For distribution of assets, distribution itself presupposes existence of an asset. Distribution cannot be applied when an asset is created and allotted[3]. In this case, shares issued by ABCL to the shareholders of GIL were never the assets of GIL and hence, the question of distribution of assets by GIL does not arise.
- The Taxpayer also refers to exception (v) to section 2(22) of the Act which provides that the term 'dividend' does not include any distribution of shares pursuant to a demerger by the resulting company, to the shareholders of the demerged company and hence, there is no distribution of any assets by the Taxpayer to its shareholders.
- The Taxpayer also refers to the CBDT circular No. 5-P dated October 9, 1967 ("Circular"), wherein it was clarified that where a company transfers assets in a Scheme, such transfer may not be regarded as distribution of accumulated profits by the company to its shareholders, even though accumulated profits are embedded in the assets transferred. Though the circular specifically deals with merger scenarios, the principle laid down in this circular equally applies to demerger scenarios as well.

Ruling of the ITAT

On demerger of *'Financial services Business'*

- The ITAT held that the Tax Officer is incorrect in holding that there was no FSB being carried out by ABNL prior to implementation of the Scheme – this is evident from the fact that the Taxpayer showed interest income (interest on inter-company deposits) as business income which was accepted by the Revenue in the past. This was also evident from the disclosures made in the tax audit report.
- Further, considering the details of assets and liabilities mix pertaining to the demerged undertaking, it is clear that the same was capable of being run as a going concern. The ITAT held that loading of an asset to the undertaking and offloading of an asset of the undertaking, both these situations will make the demerger non-compliant with section 2(19AA); which was not the fact pattern of the present case.
- In view of the above discussion, supported by documentary evidence, that FSB qualifies as an undertaking in terms of explanation 1 of section 2(19AA) of the Act and such a transaction also complies with all the conditions of section 2(19AA) of the Act in order to qualify as a tax neutral demerger, the ITAT upheld the Taxpayer's contention that this restructuring is a tax neutral transaction. While arriving at the aforesaid conclusion, ITAT also relied on the decision of the DRP which upheld the Taxpayer's contention.

[3] *Khoday Distilleries Ltd vs CIT [2008, SC] (307 ITR 312)*

On the issue of deemed dividend u/s 2(22)(a) of the Act

- Once it is established that the aforesaid transaction is a tax neutral demerger as provided u/s 2(19AA) of the Act, deemed dividend u/s 2(22) of the Act cannot arise since dividend for the purposes of section 2(22) specifically states that 'dividend does not include' any *'distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company'.*
- Additionally, the ITAT concurred with the Taxpayer who placed reliance on the Circular that exempts distribution of assets, from the ambit of 'deemed dividend' in case of a merger transaction. The ITAT held that the principle laid down in this Circular equally applies to demerger transactions as well.

On re-writing of the Scheme by the Revenue

- Approval of the Scheme by the NCLT does not preclude the Revenue from examining the Scheme from a taxation standpoint.
- The ITAT further held that the Revenue is not challenging or seeking to re-open / rewrite the Scheme approved by the Hon'ble NCLT – the Revenue is merely examining the tax implications of the Scheme, which would be the exclusive domain of the tax authorities at the time of assessment.

Dhruva Comments

The decision of the ITAT clearly spells out that a '*bonafide transaction'* involving demerger of financial services business, comprising primarily of shares held in group companies and other net assets relating to the investments and securities, along with employees, can qualify as an *'undertaking',* provided such business can be run independently by the acquirer.

The ruling also provides insights about the importance of appropriate documentation and disclosures in various documents such as tax audit report, return of income, director's report, management discussions and analysis report, etc.

The ITAT also made an important point w.r.t. powers of the revenue to examine the Scheme even after it is sanctioned by the NCLT – the ITAT held that it is open to the Revenue to examine the Scheme w.r.t. the tax implications and such examination would be the exclusive domain of the tax authorities at the time of assessment even if during the subsistence of the Scheme before the NCLT, the Revenue did not object to the Scheme or provide objections, as the case may be.

It may be kept in mind that this ruling was delivered by the highest fact finding authority (ITAT) in the specific facts of the case where a FSB together with sizable investment in an entity engaged in FSB was demerged. The ruling cannot be considered as laying down a ratio on whether demerger of a singular investment in an operating business will be meet the requirement of section 2(19AA).

Overall, this is a welcome ruling as it seeks to remove the clouds around investment business/ financial services business qualifying as a '*business undertaking'* for the purposes of a tax neutral demerger.

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